

Rental Real Estate Rising to the Level of a Trade or Business for Purposes of the Net Investment Income Tax



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Net investment income (“NII”) under IRC Section 1411 generally includes gross income from rents unless such income is characterized as non-passive **and** is derived in the ordinary course of a trade or business.

To be “derived in” a trade or business, the preamble of the proposed regulations state that the income must result from an activity that is not passive. The determination of whether the activity is passive is determined at the taxpayer (individual, estate, or trust) level in accordance with IRC Section 469. A brief summary of the rental real estate rules can be found here:

<http://keitercpa.com/client-alerts/property-owners-benefit-from-classification/>.

The rental income must also result in the ordinary course of the taxpayer’s trade or business. Neither IRC Section 1411 nor the proposed regulations provide guidance or define the meaning “ordinary course”. However, other regulation sections and case law are available to help determine whether the rent is derived in the ordinary course of a trade or business.

For NII tax purposes, the proposed regulations incorporate the definition of a trade or business within the meaning of IRC Section 162. The preamble of the proposed rules state that the most established definition of trade or business is found under section 162(a), which “permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business”. However, the term “trade or business” is not defined anywhere in the Internal Revenue Code. In the case, *Commissioner v. Groetzinger*, the Supreme Court examined what is required for an activity to rise to the level of a “trade or business” for tax purposes and determined that no specific test is available. Instead, the decision can only be made by examining the facts on a case-by-case basis and looking into whether the taxpayer devoted his or her full-time efforts towards the activity on a regular, continuous, and substantial basis.

For example, rental real estate subject to a triple net lease would not qualify as a trade or business since the lessor of such lease is not obligated to maintain and

operate the property; therefore, he would not meet the requirement of regular and continuous. There is also some controversy when management or rental activities are performed by an agent or an independent contractor or if the taxpayer is merely a limited partner in a rental real estate business. The cases involving these debates have held that the taxpayer is engaged in a trade or business if the activities performed by the agent would, if conducted by the taxpayer, constitute a trade or business.

Other authorities and court decisions have also attempted to define a trade or business under IRC Section 162 by focusing on the taxpayer’s intention to make a profit. For reference, a brief list of factors that should be considered in establishing the existence of a profit motive is included on page 3. Although answering “yes” to any of these questions tends to indicate a profit motive, the list is not all-inclusive and no single factor is determinative.

The chart below outlines the different treatment of passive and non-passive rental real estate as it relates to a trade or business defined by IRC Section 162.

	Trade or Business Under Section 162	NOT a Trade or Business under Section 162
Non-passive rental real estate	<i>Exclude</i> from NII	<i>Include</i> in NII
Passive rental real estate	<i>Include</i> in NII	<i>Include</i> in NII

It is important to note that income and gains from a non-passive section 162 rental real estate business escapes the NII tax; however, losses from the activity are also excluded from NII and cannot be used to offset rental income from other sources for NII tax purposes. On the other hand, non-passive or passive rental real estate activities that do not constitute a trade or business under section 162 will be included in NII and any rental losses can be used to offset income from other sources in calculating NII.

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In order for rental income to be excluded from NII, the income must meet the requirements set forth above; otherwise, the rents could be subject to the 3.8% surtax.

Should you have any questions related to this topic, feel free to contact your Keiter professional or our [real estate and construction industry team](#) for further clarification.

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FACTORS IN ESTABLISHING A PROFIT MOTIVE (NOT AN ALL-INCLUSIVE LIST)



	Yes	No	Comments
1. Manner in which activity is conducted:			
a. Is there a legitimate profit or gain motive?	_____	_____	_____
b. Are complete and accurate books and records maintained?	_____	_____	_____
c. Is there stationery, business cards, advertising, or marketing?	_____	_____	_____
2. Taxpayer's or adviser's expertise:			
a. Does taxpayer have prior expertise in the business?	_____	_____	_____
b. Does taxpayer seek advice from qualified advisers?	_____	_____	_____
c. If adviser's advice is not followed, are reasons documented?	_____	_____	_____
3. Time and effort:			
a. Does taxpayer devote substantial time to the activity?	_____	_____	_____
b. Are others employed to carry on the activity?	_____	_____	_____
4. Is there a reasonable expectation of asset appreciation (in lieu of operating profits)? Actual appreciation is not necessary; only an honest expectation of appreciation [<i>Holmes, Robert E.</i> , 184 F.3d 536, 83 AFTR 2d 99-2987, 99-2 USTC 50,642 (6th Cir. 1999)].	_____	_____	_____
5. Has the taxpayer previously turned a similar unsuccessful business into a profitable one?	_____	_____	_____
6. Has the activity previously generated significant profits?	_____	_____	_____
7. Are profits substantial in relation to any losses and the taxpayer's investment?	_____	_____	_____
8. Is the activity a meaningful part of the taxpayer's overall sources of income?	_____	_____	_____
9. Do profit motives outweigh any elements of personal pleasure or recreation associated with the activity?	_____	_____	_____